NEW IRS RULINGS ON TAXATION OF INVESTMENTS IN LIFE INSURANCE CONTRACTS

In two rulings issued on May 1, 2009, the Internal Revenue Service (the "IRS") clarifies its positions on a number of issues related to the purchase and sale by investors of life insurance contracts. In recent years, numerous investment funds, including life settlement funds and viatical trusts, have purchased life insurance contracts from insured persons desiring to monetize their life insurance policies. These two IRS rulings focus both on the taxation of the investors and on the taxation of insureds who transfer life insurance policies. In the case of insured policyholders selling their life insurance contracts, the IRS describes the amount subject to tax and the character of income recognized by an insured upon the surrender or sale of a life insurance contract. In the case of investors, the IRS has addressed the taxation of death benefits, the tax treatment of gain or loss realized on the resale of life insurance contracts purchased by investors, and the taxation of death benefit proceeds paid to non-U.S. investors, such as offshore funds. The IRS's conclusions are briefly summarized below.

Tax Consequences to an Insured

Revenue Ruling 2009-13 presents several conclusions as to the tax consequences to an insured policyholder of surrendering or selling an in-force life insurance contract. First, if an insured policyholder were to surrender a life insurance contract back to the issuing insurance company for the contract's cash surrender value, Revenue Ruling 2009-13 concludes that the insured would recognize as taxable ordinary income the amount by which the cash surrender value exceeds the total amount of premiums previously paid by the insured.

If the insured policyholder were to transfer, in a taxable transaction, a life insurance contract to an unrelated third party, the ruling provides that the insured would recognize as income the excess of the selling price over the amount of premiums previously paid by the insured, with the amount of premiums reduced by the already-incurred costs of providing life insurance on the insured's life. As to the character of such income, the ruling concludes that the amount of such income that does not exceed the build-up of investment return inside the life insurance contract would be treated by the insured as ordinary income, while the amount of income in excess of this amount would be treated as capital gain.

If the insured had instead transferred a term life insurance contract with no cash surrender value, the insured would be taxable on the amount realized on the sale, less the total amount of premiums paid reduced by charges for the provision of insurance before the sale. For a term insurance policy, the ruling indicates that, absent other proof, the cost of providing insurance will be deemed to equal the premiums due.

Tax Consequences to an Investor

In contrast, Revenue Ruling 2009-14 focuses on investors, not insured policyholders. In this ruling, the IRS analyzes death benefit proceeds received by an investor that has purchased from an insured (in whom the investor has no insurable interest) a term life insurance contract with no cash surrender value. The IRS concludes that any income realized upon the death of the insured would be equal to the proceeds received, less the total of the amount paid to purchase the contract and less the amount of premiums paid by the investor to maintain the contract after the purchase. This ruling provides that the income realized upon death of the insured would be ordinary income, not capital gain.

The ruling also provides that if the investor had, prior to the death of the insured, transferred in a taxable transaction a term life insurance contract to an unrelated third party with no insurable interest in the life of the insured, the income realized on the transfer would be taxable as capital gain. Revenue Ruling 2009-14, which is specifically limited to term policies, does not address the proper character of gain realized by an investor on the transfer of a non-term life policy when the gain is wholly or partly attributable to investment income built-up inside the policy. The ruling implies that gains attributable to inside build-up would be ordinary in character but does not provide the definitive holding for investors that Revenue Ruling 2009-13 does with respect to gains realized by insureds transferring non-term life policies.

In addition, Revenue Ruling 2009-14 provides that any premiums paid by a secondary market purchaser of a term life insurance contract (without cash value) to maintain the policy are to be capitalized and not deducted currently. According to the ruling, the amounts capitalized are not reduced by the allocable costs of providing life insurance on the insured's life prior to the transfer, in contrast to the treatment for an insured as set forth in Revenue Ruling 2009-13.

Revenue Ruling 2009-14 also concludes that if the investor had been a non-U.S. corporation not engaged in a U.S. trade or business (including the purchasing or taking assignment of insurance contracts), death benefit proceeds payable by a U.S. insurance company to the investor upon the death of an insured who is a U.S. citizen residing in the U.S. would be U.S.-source income. As a result, such U.S.-source proceeds, less the purchase price and additional premiums paid, potentially would be subject to U.S. withholding tax under previous guidance.

A related issue not addressed in Revenue Ruling 2009-14 is whether the amount of proceeds subject to U.S. withholding should be reduced by any interest paid or accrued, and effectively required to be capitalized under certain provisions of the Internal Revenue Code, by a non-U.S. person to finance investments in life insurance contracts.

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